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New Europe Meets the Euro

BARRY EICHENGREEN

Now that the decision has been made to admit to the European Union eight of what were formerly called the “transition economies,” attention has naturally turned to whether these countries should also adopt the euro. But while there is a consensus that joining the EU, though posing some difficulties, will be a source of net benefits for the countries concerned, there is no such consensus about the consequences of their joining Europe's monetary union.

This uncertainty stems in part from a failure to pose the “compared-to-what” question. Adopting the euro will have costs for the so-called accession economies, but so would shunning the euro. In fact, there are compelling reasons to think that adopting the euro will be less costly than the other monetary options available to the countries of “new” Europe. Their governments are thus right to be committed to a strategy of joining euroland. And the incumbents should be happy to have them. None of this is to deny that enlarging Europe's monetary union will pose difficulties for both the incumbents and the new members. But these are minor compared to the difficulties that would arise under other scenarios.

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[1]The 10 countries are the Czech Republic, Slovakia, Hungary, Poland, Estonia, Latvia, Lithuania, and Slovenia (which are the 8 central and eastern European economies that are the subject of this essay), along with Cyprus and Malta.

UNPLEASANT MONETARY OPTIONS

On May 1, 2004, 10 new EU member states will join Europe's monetary union.[1] They will not, however, be obliged to adopt the euro, the EU currency, at the outset. Although they will become part of the European System of Central Banks, they will participate only in its General Council, which is responsible for setting broad policy guidelines, not also its Executive Board, which determines the central bank's monetary policies.

What monetary options will be open to these countries subsequently? They can operate a currency board, in which the domestic currency is rigidly linked to the euro, as Estonia for example presently does, or they can adopt the euro unilaterally, at least if the EU does not penalize them for doing so. (The European Commission and the incumbent member states have made clear that they will not look favorably on unilateral euroization.) For countries tilted in these directions, joining the euro zone is clearly the better alternative. Their monetary policy will be the same either way—it will be determined in the Eurotower in Frankfurt, where the European Central Bank meets. But only if they quickly become full members of the central bank will they have a voice in its formulation.

Another option for the new EU members is to float their currencies, even though the currencies will not be able to float freely. The United Kingdom and Sweden, which seem comfortable with their own currencies, can allow their exchange rates to float freely because their debts are denominated in British pounds and Swedish krona, respectively. Most of the debt issued by the new EU members, in contrast, is denominated in foreign currencies, mainly euros and dollars. Consequently, when their exchange rates weaken, the cost of servicing these debts goes up, worsening the financial condition of banks, firms, and the governments themselves. To limit these effects, they heavily manage their exchange rates, limiting their fluctuation. In turn, this means there are restrictions on how freely they can use monetary policy as a stabilization device.

This leaves the option of limiting the currency's movement to a narrow fluctuation band (where the authorities commit to preventing the price of foreign exchange from moving beyond pre-specified upper and lower limits). But bands are fragile and difficult to maintain. Their collapse can severely damage the credibility and tarnish the reputation of the national monetary authorities. This is clear from Europe's own experience in 1992, when the Italian lira, the British pound, and several other currencies governed by the narrow bands of the then-prevailing Exchange Rate Mechanism were attacked.

A more recent illustration of the difficulties of managing an exchange-rate band, and the consequences of failure, was provided by Hungary in May 2003, when it devalued the forint by 2.3 percent, presumably with an eye toward adjusting its currency to a more competitive level prior to entering the European Union. Investors, caught off-guard, did not react favorably. The exchange rate immediately fell an additional 6 percent, forcing Hungary's central bank to raise interest rates sharply in order to defend the forint and inadvertently inflicting damage on the Hungarian economy. This crisis did nothing to enhance the reputation of the country's policy makers. The latter have been trying desperately, without much success, to regain the market's confidence ever since. At the beginning of 2004, interest rates on five-year forint paper were still at 10 percent (7 percentage points above the rates of German bonds).

The new EU members will have to show an ability to live within their fiscal means if they are going to be part of Europe's monetary union.

Consigning the accession economies to a new Exchange Rate Mechanism (an ERM-II as it will be called) as a half-way house on the road to the euro area sets them up for precisely the kind of crisis that Europe suffered in 1992. Hopes that they will successfully navigate the transition to monetary union and its lower interest rates have already stimulated capital inflows of so-called convergence plays in which speculative capital surges into the region in anticipation of lower future inflation and hence higher bond prices. Revealingly, central and eastern Europe is the only emerging region that received significant net debt flows in 2003 ($17 billion). But both domestic political disruptions and statements emanating from Brussels and Frankfurt could interrupt this happy state of affairs without warning. Those flows would then turn around, bringing the entire house of cards—including the ERM-II—crashing down, damaging confidence and precipitating a serious recession.

By process of elimination, it would appear that joining the euro zone sooner rather than later is the best option. As it stands, the new EU members already possess limited monetary autonomy and can tolerate little exchange rate variability. Joining the euro area will render their monetary policies more predictable and their finances less fragile. It will give them at least some say over a monetary policy that they would otherwise have to take from Frankfurt as a fait accompli. To be sure, they would be even better off if their labor markets were more flexible. While their labor markets may be somewhat less rigid than those of western Europe, in recent years wages in central and eastern Europe have shown a distressing tendency to be flexible only in the upward direction. The new members would also find monetary union more comfortable if labor mobility between eastern and western Europe were higher and specifically if it were not restricted by the incumbent EU members for a transitional period of six or seven years, which is the current plan. That said, more flexible labor markets are equally important to central and eastern Europe whether or not the new EU members join the monetary union.

Given the advantages to the accession economies of joining the euro club, why do the incumbents evince reservations about their early entry? One answer is that they fear that expanding the euro area will subject the European Central Bank to additional inflationary pressure. So long as they are catching up with the west, the new EU members will experience relatively higher inflation. If their economies grow faster than western Europe's, the local prices of services (for example, housing services, and therefore real estate prices) will rise faster in the east. In turn this may create fears that the European Central Bank, in order to damp down inflation, will be compelled to maintain a tighter monetary stance than is appropriate for slower growing western Europe. The result would then be stagnant consumption and investment in the west.

But if this is what the incumbents fear, it is unwarranted. On a GDP-weighted basis—which is the basis on which central banks like the European Central Bank think about policy—the new members of the monetary union will be too small to influence much the unionwide rate of inflation. Emphasizing this fear is a little bit like saying that the US Federal Reserve Board's policy decisions are being driven by the rate of increase of housing prices in Wyoming. Only after the accession economies experience relatively rapid growth for an extended period and their per capita incomes catch up with levels in western Europe will their weight in European Central Bank decision making increase significantly. And by that time they will be considerably richer, by definition, and their inflation rates will have converged to western European levels, obviating the problem.

Another explanation for the incumbents' reservations about accession economies' quickly joining the euro is the fear that the European Central Bank might feel compelled by financial problems in the new member states to intervene with a large-scale liquidity injection, undermining its anti-inflationary resolve. In the typical scenario, the new members would run excessive deficits and accumulate unsustainable debts. Panic sales of those debt securities by bondholders might then precipitate a crisis in Europe's bond markets and the continent's banking systems, to which the European Central Bank would have to respond in inflationary fashion.

Yet, while there is no question that the new EU members have fiscal work to do, the danger they pose to the financial stability of euroland and the anti-inflationary credibility of the European Central Bank is in fact considerably less than in the case of the incumbent members. The fact of the matter is that their debts are small. Problems in, for example, the Hungarian bond market are unlikely to destabilize the bond markets of western Europe, which are an order of magnitude larger. If Hungary experiences a debt crisis, the consequences will be largely limited to Hungary. This makes it more likely that the European Central Bank will simply stand aside and let events run their course. This will have various consequences, both good and bad, but inflation will not obviously be among them.

A final reason why the incumbents may be reluctant to admit as many as 10 new members to the monetary union is that doing so will render the European Central Bank board unwieldy. The institution might then be forced to move to a rotation system, not unlike that used to constitute the Open Market Committee of the US Federal Reserve System, in which certain members—in the European case, certain large EU member states—would periodically rotate off the board, leaving their countries without a vote. France and Germany, in other words, are reluctant to see their influence on the European Central Bank executive board diluted. If this is what is fueling their reluctance to accept new members, it is selfish and short-sighted.

THE DANGER TO CURRENCIES

Against this background, the suggestion by Pedro Solbes, the EU's commissioner for economic and monetary affairs, that the new EU members may be expected to adhere to the narrow (2¼ percent) exchange-rate bands of the ERM-II for fully two years as a precondition for adopting the euro is particularly alarming. As we learned in 1992, requiring countries to hold their currencies within the ERM's narrow bands for an extended period is risky business. The new EU members will want to follow policies consistent with early admission to the monetary union, but they will also have to attend to their domestic economic needs, and in particular to the implications of policy for their governments' reelection prospects. If doubts develop in the minds of investors about how these priorities will translate into interest-rate policy, capital could start to flow out, forcing their central banks to raise interest rates sharply to attract it back.

Higher interest rates are not helpful, of course, for the employment situation. Thus, a loss of confidence would place the authorities in the unenviable position of having to choose either to raise interest rates in order to hold open the possibility of admission to the monetary union sometime down the road, or not raise them to avoid aggravating the unemployment problem now. Politicians find it difficult to delay gratification, so there is the danger that a loss of confidence, even if unwarranted, could tip the balance. Forced to pay an even higher price now for the promise of monetary union later, a loss of confidence might lead them to abandon a peg that they would have otherwise happily maintained.

This risk is greater with narrow bands than wide bands, as the EU learned after moving from 2¼ percent bands to 15 percent bands in 1993. If a successful speculative attack (in which investors all line up on one side of the market, in this case selling the currency en masse) leads a government to abandon hope for early admission to the monetary union, causing it to shift to a more accommodating monetary policy, the attack will precipitate a sharp drop in the exchange rate, conferring significant gains on currency speculators. If the attack is unsuccessful, on the other hand, the exchange rate will barely move, confined as it is to narrow bands. Currency speculators will then lose nothing. In effect, this means that they are being offered a one-way bet. There will thus be nothing to deter them from speculating against the government and central bank.

Under wide bands, in contrast, there is a two-way bet—that is, speculators must contemplate the possibility of losses as well as gains, since the currency can strengthen as well as weaken. Moreover, if early birds develop doubts about future prospects, the currency can weaken considerably within the band before the central bank is forced to take action. When other investors decide whether or not to pile in, they must recognize that if the currency eventually recovers to its initial position within the band—a reasonable expectation on the assumption that nothing else changes—they will incur losses on their positions. This helps to limit both herd behavior on the part of investors and the intensity of the speculative pressures with which the central bank must cope.

This problem of adverse speculation prompted by the availability of one-way bets is likely to be even greater with the ERM-II than with the ERM that prevailed in the 1980s and early 1990s. There will, for example, be no capital controls analogous to those that restrained the intensity of currency speculation in the first decade of the original ERM. The accession economies are required to remove all controls on capital movements as part of the process of accepting the *acquis communautaire* (the body of EU laws and treaties) that is obligatory for all EU members.

Moreover, there is reason to think that the European Central Bank will feel only limited obligation to intervene on behalf of the accession economies or to provide them with short-term financing to support their currency pegs. The old ERM was in some sense all for one and one for all. A crisis that jeopardized one country's participation might jeopardize the entire system, as Europe learned in 1992–1993. To be sure, there were limits on how far strong-currency countries like Germany would go to support their weak-currency counterparts, but there is no question that a perception of shared interest in the system existed.

Now the situation is different. Whereas in the old ERM there were currency bands for all participating currencies, including the deutschmark, under the ERM-II the euro itself will not have bands; these will apply only to the currencies of the accession economies. If one of these countries is forced to exit the ERM-II or the system collapses, this will not much affect the value of the euro. It is correspondingly more likely that the European Central Bank will invoke the provisions of the ERM agreement that allow it to withhold support until a currency has reached the edge of its fluctuation band and then to halt withholding if it fears that price stability is threatened. And currency speculators know this, which makes it all the more likely that they will act.

For all these reasons, a narrow-band ERM-II would be extremely fragile. While wide bands of plus-or-minus 15 percent like those of the post-1993 ERM would be better, no bands would be best of all, for there is a sense in which the case for them is anachronistic. Before the euro existed, it was possible to make a case for bands, on the grounds that EU member states needed to be prevented from engaging in exchange rate manipulation that might corrode cohesion and even threaten the single market. But now the monetary union exists, and the new member states want in. If they are allowed a reasonable transition path, most if not all of them will enter relatively quickly, rendering any intervening exchange rate fluctuations transitory and therefore of only ephemeral impact on the single market. This suggests focusing on the budgetary criteria to determine whether they are capable of running sound and stable policies. If they fail to do so, they will not be allowed to enter the monetary union. But then they will not be able to operate narrow bands either. There is no case for the ERM-II either way.

PROSPECTS FOR FISCAL REFORM

Assume that the European Commission sees the light and relaxes its interpretation of the exchange-rate criterion for entry by the new members into the eurozone, as it should. The major challenge for accession economies seeking to adopt the euro will then be fiscal adjustment, since presumably they will be expected to satisfy another criterion set down at the time the Maastricht Treaty was adopted, namely, to bring their budget deficits down to less than 3 percent of GDP.

To be more precise, this will be the major challenge for the four central European economies: the Czech Republic, Hungary, Poland, and Slovakia (the so-called CEE4). There is a striking divergence between the budget deficits of the CEE4, which have exploded, and those of the smaller accession economies, which remain firmly under control. While the definitive numbers for 2003 are not yet in, most observers anticipate deficits on the order of 5 to 7 percent of GDP for the Czech Republic, Hungary, Poland, and Slovakia. The deficits of the small accession economies are either very close to 3 percent (in the cases of Latvia and Lithuania) or already significantly below that threshold (in Estonia and Slovenia).

Given that a budget deficit of less than 3 percent of GDP is a precondition for qualifying for euro adoption, significant steps to narrow these deficits will have to be taken soon if the CEE4 countries are serious about adopting the euro by the end of the decade. The question is whether the Czech Republic, Slovakia, Hungary, and Poland will be able to tolerate the unpleasant consequences.

To get a sense of the answer, it may be useful to ask why the fiscal positions of the large and small countries diverged in the first place. One factor is surely the different value that large and small countries place on monetary union itself. Small countries benefit more from the convenience of the common currency; for them, the threat that inadequate budgetary discipline will mean a delay in entering the monetary union is an effective deterrent to fiscal profligacy. The large countries are less impressed by this threat. Poland, with 40 million residents, may feel the same ambivalence as the United Kingdom about compromising social priorities in order to adopt the euro. Compared to Estonia, it consequently feels less pressure to rein in deficit spending.

Forcing the accession economies to hold their exchange rates within narrow bands for at least two years as a precondition for entry would be a recipe for disaster.

But, as argued earlier, any benefits that the large countries currently perceive from staying out of the euro will prove short-lived. These countries are not going to have an easy ride either in or out of the ERM-II. Again, many of their foreign liabilities are euro-denominated, limiting their monetary autonomy. This suggests that they too will come to appreciate the advantages of adopting the euro, although they may learn this the hard way, after a period of macroeconomic and financial turbulence and a delay in fiscal consolidation.

A second difference between the CEE4 and the Baltic states is their style of regulation and the extent of their welfare states. The big central European countries are becoming "Westernized" in the sense of obtaining western-European-style structured labor markets, regulated product markets, and generous welfare states at a rapid—some would say an alarmingly rapid—rate. The welfare-state-related transfers that account for a large share of the increase in their public spending are notoriously difficult to cut. The Baltics are more market-oriented and have smaller welfare states. It may follow that they are less prone to deficits.

Third, political business cycles may operate less powerfully in small countries. Pump priming through deficit spending before elections is less effective because the leakages through imports are greater. In addition, manipulation of the economy in the run-up to elections may be more transparent and hence less effective.

Fourth, the small countries have more efficient budgetary institutions that are less prone to free riding and faster to respond to shocks. The evidence for this comes from the work of the German economist Holger Gleich, who has constructed indices of the efficiency of budget institutions for the 10 accession economies. Gleich assigns higher rankings to countries whose institutions are conducive to coordination and cooperation in decision making, which should promote fiscal discipline. (The relevant coordination mechanisms include the delegation of budgetary power to a strong finance minister or prime minister, and mechanisms for facilitating communication among competing interest groups leading to binding decisions.) Estonia, Latvia, and Slovenia have the three best scores in terms of the efficiency of their budgetary institutions, while Hungary and Poland have two of the worst. This is consistent with the idea that the CEE4 have more serious fiscal problems because they have more unwieldy budgetary processes.

Finally, fiscal control simply may be harder in larger, more decentralized economies. Where there are more regional governments and spending ministries, there is a more pronounced common pool problem—a greater temptation for each to spend more now and ask for a transfer from the central government later. Where there is more ethnic and economic heterogeneity, there may similarly be a greater tendency for each group to demand more spending on its particular need, to the neglect of the aggregate consequences. Institutional reforms that make the budgeting process more centralized can address this problem, but there are limits to centralization in large, diverse economies. And delegating agenda-setting power to a strong finance minister tends to be effective only when there is a strong one-party government, which is not the norm in this part of the world.

WHEN ECONOMICS AND POLITICS COLLIDE

None of this means that fiscal consolidation is impossible in the larger accession economies, only that it faces hurdles not also present in the smaller countries. But the preceding discussion raises troubling questions about the feasibility of some countries' consolidation strategies. Hungary, for example, proposes to embark on an ambitious three-year deficit-reduction plan culminating in an evaluation of its readiness for monetary union in 2006 (with an eye toward entry in 2008). Unfortunately, this will collide with the next round of general elections, which creates worries that the authorities' fiscal goals may end up being sacrificed on the altar of electoral politics. The structure of the country's fiscal institutions does not suggest that this problem will be easily addressed.

The new EU members will want to follow policies consistent with early admission to the monetary union, but they will also have to attend to their domestic economic needs.

The pressure to abandon consolidation will depend, of course, on whether initial efforts at belt-tightening aggravate macroeconomic problems or help to solve them. Economists have pointed to circumstances where, at least in theory, fiscal consolidation can be expansionary, contrary to the conventional Keynesian wisdom. But while theory is one thing, practice is another. In practice, the question is whether the large accession economies meet the preconditions for this exceptional case where deficit reduction stimulates growth and reduces unemployment.

A first such condition is exchange-rate flexibility. Fiscal consolidation does least to aggravate unemployment when the exchange rate is flexible; the decline in domestic absorption can then stimulate exports through a weaker currency. But this mechanism will not be operative in countries that immediately enter the ERM-II. It will only benefit the others to a limited extent, given that the euroization of their liabilities will in any case prevent them from allowing their currencies to depreciate too far.

In addition, to the extent that the budgetary imbalance stems from a public sector that is too large or growing too rapidly, fiscal consolidation will only be sustainable if it addresses this core problem, which means limiting the growth of spending rather than raising taxes. That this is the medium-term strategy (meaning that it would start in 2005 or 2006) in all the large accession economies is reassuring.

But, in truth, most of these countries display little appetite for cutting spending now. Hungary is relying mainly on tax increases to address its immediate fiscal problem, reflecting the fact that the vast majority of expenditure takes the form of programs that are politically difficult to cut. Thus, the government's 2004 budget proposal foresees no reduction in the expenditure/GDP ratio, which will remain at 48 percent of GDP. Reductions in the public expenditure ratio will only kick in later. In Poland there will be no decline in the government expenditure/GDP ratio between 2003 and 2004, according to the 2003 Pre-accession Program; to the contrary, it will rise further, to 48 percent of GDP. Expenditure reductions are scheduled to kick in only later, starting in 2005.

It is not hard to see why. Social transfers account for a substantial share of general government expenditure, and this component of the budget is notoriously difficult to cut. The same 2003 Pre-accession Planning Programs that project eventual declines in the share of general government expenditure foresee no decline in social transfers as a share of GDP (aside from a limited decline in Poland).[2] Some economists have argued that we should not worry about large deficits in these countries, because there is still ample scope for productive public investment. They argue similarly that one should not be alarmed by the absence of more rapid public expenditure reduction, since the new EU members need to match

[2]Discussions subsequent to the Pre-accession Planning Programs on issues like pension reform point in more optimistic directions, at least for some countries. Pension reform that more closely links benefits to contributions and raises the retirement age or limits the indexation of benefits, where doing so is needed to put the scheme on a sustainable footing, is important for sending a signal that pension systems will not remain a major drain on the general government budget. Poland proposes changes in pensions indexation that promise to save 0.3 percent of GDP per annum in 2004–2007. The Czech government has proposed a modest change in pension indexation that will save 0.1 percent of GDP in 2004–2006.

their receipts from the Cohesion Funds (the transfers that low-income member states receive from the EU budget). But when one sees the large share of national income absorbed by public spending and how much of this takes the form of transfer payments, it is clear that what is needed is expenditure reduction, not more deficits.

Finally, several of these medium-term fiscal scenarios, notably those for Poland and Slovakia, are based on overly optimistic growth forecasts. Their governments are projecting declines in the deficit by making exceedingly rosy assumptions about revenues. They see public spending as a fraction of GNP declining not as a result of slower growth in the numerator but faster growth in the denominator. Households, firms, and financial markets are likely to see this rosy scenario for what it is. Their awareness that the authorities have taken only half-measures means that consumer and investor confidence will be less than otherwise. And this in turn means that consolidation is less likely to be expansionary.

None of this is intended to question that fiscal consolidation is needed in the large accession economies. Nor do these observations necessarily question that it will happen. But they do question the assumption that it will be painless. Hence, there are likely to be reversals along the way. The process may take several additional years to complete.

WHICH STATES, AND WHEN?

Given all this, what would be the sensible way of deciding which new EU member states to admit to Europe's monetary union, and when? Forcing the accession economies to hold their exchange rates within narrow bands for at least two years as a precondition for entry would be a recipe for disaster, given the fragility of such bands in an environment of high capital mobility. Forcing them to run inflation rates within 1 percent of those of the three lowest-inflation members of the eurozone (another precondition set down in the relevant protocol to the Maastricht Treaty) would be perverse, given the natural—even healthy—tendency for inflation to run higher in fast-growing catch-up economies.

This leaves the fiscal conditions of the Maastricht Treaty, which state that to qualify for participation in the monetary union countries must have budget deficits of less than 3 percent of GDP and debts of less than 60 percent at the time of evaluation. While the economic rationale for these precise thresholds can be disputed—as can all things economic—of all the criteria set down at Maastricht these make the most sense. The new EU members will have to show an ability to live within their fiscal means if they are going to be part of Europe's monetary union. If they do not, they will eventually run up against problems of debt sustainability. And without a national central bank to bail them out, the resulting debt crisis could prove to be highly disruptive to the country in which it originates.

But does this not amount to a double standard, since late in 2003 the Council of Ministers declined to hold France and Germany to these same fiscal standards? Recall that the European Commission had recommended in favor of fining these countries for violating the 3 percent deficit ceiling, but the national governments—led not surprisingly by those of France and Germany—refused to act on that recommendation. The commission subsequently filed suit against the governments of the member states in the European Court of Justice to compel them to accept its recommendation, but it may take several years for the case to be decided. Whatever the outcome, there is a clear feeling now that the procedures ostensibly to be applied to fis-

A *Current History* Snapshot . . .

"There are two ways for attempting to achieve European unity. One way is to try to form at the start a complete federal structure with a federal parliament, elected by the people, with power to legislate on many subjects—tariffs, military defense, taxation. This would mean a very serious limitation on existing political sovereignty. It is bound to meet very stiff opposition, and in fact has so far been unsuccessful in Europe. The second way would be to begin modestly and gradually with international agreement on a few practical matters, economic rather than political. If these work satisfactorily, they will accustom people psychologically to the idea of further cooperation in more fundamental matters, and may finally lead them to agree to the final crowning step of establishing a federal parliament."

"Toward European Unity"
Current History, June 1952
Sidney B. Fay, Harvard University

cally irresponsible members of the monetary union have no teeth. Why then should similar criteria be applied to potential new entrants?

The answer depends on what lesson one draws from this diplomatic spat. One conceivable lesson is that multilateral surveillance of national fiscal policies is either superfluous or impractical, and that the Stability and Growth Pact under which it has been conducted should simply be allowed to die a quiet death. If so, it would indeed be a double standard to require the accession economies to meet essentially the same fiscal requirements as a precondition for adopting the euro, when the incumbent members of the eurozone are not also required to do so.

IF COMMON SENSE PREVAILS

But the more likely lesson is that the Stability Pact should be reformed rather than abolished. It should be reformed in the direction of greater flexibility, giving the national governments that are its subjects more freedom to run deficits in recessions, so long as these are offset by surpluses in expansions. Essentially, this would mean paying more attention to medium-term fiscal performance and putting less weight on year-to-year fluctuations in the budget balance. For example, countries whose debts were significantly below the 60 percent of GDP threshold and which were therefore highly unlikely to encounter problems of debt sustainability might be granted significantly more freedom to run budget deficits if they so chose. But if this reform were applied to the incumbent members of the monetary union, it should logically be applied to the accession economies that aspire to join as well. The implication is clear, since, as was noted, most of the accession economies have relatively low debts.

In addition, the Stability Pact could be reformed to pay more attention to medium-term budgetary prospects. Countries with rapidly aging populations and unfunded public pension liabilities should be cut less slack if their current budget deficits rise significantly above 3 percent, since their demographics and pension obligations imply the need for even higher levels of spending down the road. Here the prospects for the accession economies are less positive, since many of them have aging populations, and several have only begun to fund their unfunded pension schemes. Similarly, countries with more efficient budgetary institutions that are faster to respond to shocks could be entitled to more fiscal autonomy, since there is less reason to think that deficits today are a leading indicator of deficits tomorrow that will ultimately culminate in problems of debt sustainability. Here the implications for the accession economies are mixed, since some have much better designed fiscal institutions than others. Still, this reform makes sense, since it will ratchet up the pressure for reform of fiscal institutions and procedures where this is needed most.

All this may mean a few additional years before the large accession economies are accepted into the euro area. They will find it easiest to complete their preparations if they are not at the same time required to participate in the ERM-II, especially one with narrow bands. But neither will life be pleasant outside the ERM-II. It too will almost certainly be a rough ride. This will further drive home the advantages of belonging to Europe's monetary union. Requiring the new EU members to participate in the ERM-II would of course have the same effect, but perversely make it more difficult for them to complete their preparations. If the incumbent members have the common sense to abandon their ERM-II requirement, there is no reason why the large accession economies cannot join a euro area that already includes Estonia, Latvia, Lithuania, and Slovenia by the end of the decade. ■